

# *Financing Strategies for Urban Infrastructure: Trends & Challenges*



*Harun R Khan*

*Reserve Bank of India*

*Mumbai, July 18, 2013*

*Conference on Financing Strategies for Urban Infrastructure*

*Organized by*

*Centre for Advanced Financial Research and Learning (CAFRL)*



# Structure of the presentation

- ❖ Urbanization: Current Pace & Future Needs
- ❖ Current Private Financing Strategies & Issues
- ❖ Urban Infrastructure Financing Institutions
- ❖ Challenges & Strategies For Financing Urban Infrastructure
- ❖ Concluding Thoughts

# *URBANIZATION: CURRENT PACE & FUTURE NEEDS*



# Urbanisation: current pace & future needs

- ❖ Urbanization in India is an important determinant of national economic growth and poverty reduction
  
- ❖ Urbanisation is central to India's strategy of faster and inclusive growth
  - ❑ agglomeration and densification of economic activities and habitations in urban conglomerations stimulates economic efficiencies
  - ❑ facilitates greater entrepreneurship and employment opportunities
  - ❑ strong rural-urban linkages catalytic for realization of the potential of urbanisation
  
- ❖ Urbanization in India is characterized by increase in the number of cities
  - ❑ with 5 cities in 1951 to 53 in 2011 and projected to about 68 in 2030
  - ❑ Mumbai and Delhi will be among the five largest cities in the world by 2030



# Urbanisation: current pace & future needs

- ❖ Degree of urbanization is accelerating
  - ❑ in the decade 2001-11, share of persons living in urban areas rose by 3.35 per cent (as against only 2.10 per cent in the decade 1991 to 2001)
  - ❑ about 31 per cent (377 million) of Indian population live in urban areas (Census 2011)
  - ❑ Only one state now (Tamil Nadu) is more than 50 per cent urbanized – by 2030 it would be 5 states
  
- ❖ Contribution of the urban sector to GDP
  - ❑ risen from about 38 per cent in 1970–71 to 63 per cent in 2009–10 and around 70 per cent at present while employing only 27 per cent of the work force
  - ❑ the top 100 largest cities in India produce 42 per cent of GDP with 16 per cent population and just 0.24 per cent of land area



# Urbanisation: current pace & future needs

- ❖ Need for a comprehensive framework of urban policy & planning for quality infrastructure, services & growth & productivity enhancing environment
- ❖ Municipal fiscal sector is tiny in India
- ❖ Total municipal revenue in India accounts for about 0.75 per cent of the country's GDP - 4 to 6 per cent in Poland, Brazil & South Africa
- ❖ ULBs account for about 2-3 per cent of the combined revenue and expenditure of Central Government, State Governments and ULBs
- ❖ McKinsey Study (2010) on Indian urbanization projects a capital investment need of US\$ 1.2 trillion over the 20 year period 2010-2030
  - ❑ this implies that India has to boost its annual per capita urban capital spending from US\$ 17 (as compared to US\$ 116 in China, US\$ 127 in South Africa and US\$ 391 in UK) to US\$134

# *CURRENT PRIVATE FINANCING STRATEGIES & ISSUES*



# Municipal Bonds

- ❖ Municipal financing traditionally through budgetary allocations/internal revenues of ULBs
- ❖ Since 1997, only 28 municipal bond issues by a few municipalities have taken place in India and mobilized nearly ₹30 billion – most of them private placements
- ❖ Most of the municipal bonds have been issued without a government guarantee
- ❖ Most bond issues to fund water supply & sewerage projects – easier enforcement of user charges/tariffs & predictability of revenue generation
- ❖ Despite weak finances of the ULBs, none of the municipal bond issues have defaulted in repayment
- ❖ No issue after 2010
- ❖ Very few ULBs appear to be planning for market borrowing as a source of finance for them despite credit rating by MoUD.



# Municipal Bonds

- ❖ Plausible reasons for inability to access markets
  - investment grade ULBs do not have cost effective access to finance as they are still considered to be riskier than corporates of same rating
  - development of market is significantly linked to the financial position of states
  - absence of active secondary bond market
  - budgeting and accounting systems of ULBs still lack transparency
  - poor project evaluation & lack of specialized project management support
  - no statutory backing for insolvency of ULBs



# Pooled Finance

- ❖ Encourages state governments and mid-to small-sized ULBs to pool their projects to achieve a marketable size of the pooled bond issuance
- ❖ Provides risk mitigation for the investors
- ❖ Reduces interest cost and are rated higher than those of the underlying borrowers
- ❖ Usage has been low
  - ❖ only Tamil Nadu (Tamil Nadu Urban Development Fund) & Karnataka (Karnataka Water & Sanitation Pooled Fund) have issued municipal bonds by pooling
- ❖ Pooled Finance Development Fund (PFDF) of GoI for credit enhancement
- ❖ Need to address pending issues related to pooled financing, such as, legislative sanctions, streamlining approval process, addressing data gaps and establishment of Urban Infrastructure Funds to expand the use of pooled bond issues



# PPP

- ❖ 12<sup>th</sup> Plan estimates about 13 - 23 per cent of the total investment requirement in urban sector can potentially come through PPPs
- ❖ PPPs are structured around a robust revenue model including user charges, targeted subsidies and viability gap funding
- ❖ PPPs provide better return prospects on risk capital and serve as an important instrument for enhancing efficiency in the delivery of urban services
- ❖ Mixed experience – failure in Pune Municipal Corporation (PMC) – success for water supply projects in Karnataka & Nagpur
- ❖ Challenges: commercial viability, low user charges, small size/value of projects, lack of strong internal revenue base to engage private finance
- ❖ Opportunities under JNNURM due to reforms & part finance support
- ❖ Challenges – regulatory clearance – lack of participatory process
  - ❖ Is PPPP (JNNURM II) the way out?



# External Commercial Borrowings

- ❖ Under the extant ECB policy urban infrastructure includes: water supply, sanitation, sewage projects.
  - the definition of urban infrastructure is under revision & being expanded to include: (a) urban public transport and (b) water and sanitation
- ❖ A large part of the ECBs (about 40-45 per cent) have been channelled to the infrastructure sector
- ❖ With the expanded list, there is greater scope for ULBs to enable corporate to access foreign funds through bankable PPP projects and avail of the concessions that have been prescribed for Infrastructure Sector including Urban Infrastructure
- ❖ While the external debt could help diversify the funding sources, excessive reliance on the same could pose risks when the availability of funding liquidity is subject to sharp volatility in the international markets, making the debt rollovers difficult or rollovers are possible only at high interest rates besides currency & tenure mismatch risks

# *URBAN INFRASTRUCTURE FINANCING INSTITUTIONS*



# Public Financing Institutions

- ❖ Term lending is an important means to finance infrastructure development but has remained modest
- ❖ HUDCO's lending to the sector accounted for about 20 per cent of overall lending : HUDCO & LIC on a declining trend – bank lending too has stagnated
- ❖ Problem lies with lack of good projects in urban infrastructure, diminishing ability to extend state government guarantee & recovery related issues
- ❖ IL&FS , IDFC, etc. are other specialized public financing institutions for urban development – mainly to SPVs/private infrastructure providers

## ***Pooled Municipal Debt Obligation (PMDO) credit facility***

- ❖ IL&FS, in partnership with IDBI, IIFCL, Canara Bank and eleven domestic banks launched this ₹30 billion facility in 2008 for
  - structuring requirement of resources for projects in a bankable format and
  - providing credit for setting up mandated projects at reasonable rate of interest

# Multilateral Financing Institutions



- ❖ Multilateral institutions like Asian Development Bank & World Bank have financially supported some of the urban infrastructure development initiatives (e.g., Delhi Metro by the ADB)
- ❖ Issue of service delivery accountability, lack of expertise with ULBs, perception of opacity & risks



# Bank financing – regulatory framework

- ❖ Reserve Bank has provided certain concessions/relaxations with regard to lending to infrastructure sector
  - ❑ enhancement in single/group borrower limits, permission to issue guarantees favouring other lending institutions in respect of infrastructure projects, asset classification benefits under restructuring guidelines, permission to extend finance for funding promoter's equity subject to certain conditions, *etc.*
- ❖ Banks are permitted to finance SPVs, registered under the Companies Act, set up for financing infrastructure projects
- ❖ Allowed debts due to the lenders in case of PPP projects to be considered as secured to the extent assured by the project authority in terms of the Concession Agreement
- ❖ Direct lending for monitorable projects but not for budget financing
- ❖ It is a well known fact that banks are primarily leveraged on short-term liabilities and as such their ability to extend long-term loans to the infrastructure sector is limited
  - ❖ This is because, by doing so they get into serious asset-liability mismatches
- ❖ SLR status – takeout financing – IDF – are they the possible wayouts?

# *CHALLENGES & STRATEGIES FOR FINANCING URBAN INFRASTRUCTURE*



# Enhancing own resource mobilisation capacity

- ❖ A strong revenue position is required for the ULB not only for its own sake but also to attract private investment
  - ❑ results in an improvement in '*municipal credit worthiness*'
- ❖ Enhance the ability of ULBs to have consistent revenues so that their bonds are seen as almost completely free from default risk

## State Fiscal Position & Intergovernmental Transfers

- ❖ Good fiscal credentials and good ratings of ULBs not a necessary condition for attracting private investors
  - ❑ weakness of the concerned state government's fiscal and financial position is also an important factor
- ❖ Most of the ULBs depend upon the devolution of resources and grants from the State government in addition to their 'own' and 'shared' revenues
- ❖ Need for establishing/strengthening State Finance Commissions (SFCs) by all States for transparent & predictable transfers in an efficient manner



# Improving the database for ULBs

- ❖ Rating agencies take a long time to assign rating to ULBs mainly due to non-availability of systematic information on most of the parameters
- ❖ Need for standardisation of financial recording and reporting formats by ULBs
- ❖ Government needs to take the lead in
  - ❑ devising a uniform pattern of budgetary and accounting practices
  - ❑ improved compilation/reporting/ dissemination of financial data relating to ULBs
- ❖ 13<sup>th</sup> Finance Commission recommendations for adoption of National Municipal Accounts Manual of MoUD

# Developing the domestic debt market

- ❖ There is a need for further deepening the bond markets and encourage municipalities to tap them for urban infrastructure
- ❖ Greater disclosure standards and an effective dispute-resolution mechanism are required
- ❖ Review the fixed cap on tax free interest on municipal bonds as it does not respond to market conditions and makes municipal bonds unattractive
- ❖ Review norms for pension/insurance/provident funds for financing the urban infrastructure



# Upscaling PPPs

- ❖ PPPs should become the default mode of undertaking projects in the urban sector
  - ❑ create commercially viable and bankable projects
  - ❑ encourage PPP mode through monetizable models, project specific SPVs, well-structured 'Requests for Proposals' and draft contracts ensuring a fair and balanced relationship with clear and realistic risk allocation
- ❖ Effective governance is key to the success of private investment

## Unlocking land value

- ❖ Land in the urban areas can be tapped for generating resources for supporting sustainable urbanization
- ❖ The Report on Monetizing Land prepared for the 13<sup>th</sup> Finance Commission has presented a case for financing urbanization using land based instruments
- ❖ Vacant land tax could be an important source of financing
- ❖ A comprehensive registry of urban land at all levels of government is needed as a first step towards putting land based instruments to good use



# Potential role of Micro-finance Institutions

- ❖ About 25 per cent of India's urban population live in slums and urban development cannot be carried out by neglecting slums
  - ❑ the potential with MFIs could be explored and exploited to ensure better service delivery in sectors like water supply and sanitation and home improvement lending in urban areas through micro loans
  - ❑ Low delivery cost, absence of bureaucratic processes & local feel are their USPs
  
- ❖ Recent problems of MFIs – lack of enthusiasm of public authorities/political class – perception that it is for rural areas only

# Enhanced scope for multilateral/bilateral loans

- ❖ Multilateral/bilateral assistance has been an important contributor to urban infrastructure financing, albeit at a lower scale so far
- ❖ 12<sup>th</sup> Plan estimates about 8 per cent of the total projected urban transport infrastructure investment requirements have to come from multilateral/bilateral loans
- ❖ ULBs need to improve their credit worthiness and overall bargaining power so as to access international finance at cheaper rates with suitable state/central government guarantees besides management of forex & other risks



# Regulatory framework to address municipal defaults

- ❖ Process of handling municipal default is opaque
- ❖ Default is handled through a three-way negotiating process involving the borrowing municipality, the relevant state government, and the investor
- ❖ The process is generally *ad hoc* and usually affected by a range of political and commercial considerations
- ❖ There is a need for a well laid down default resolution mechanism for municipalities

## Best practices & innovations

- ❖ Best practices & innovative experiments undertaken by some of the ULBs and State Governments include local resource mobilization, expenditure management, raising debt funds and in engaging with private sector
  - ❑ these need to be discussed and disseminated widely
- ❖ Need for a national institution to collate & communicate urban best practices and innovations by urban local bodies in the country and outside

# Professional management in ULBs



- ❖ ULBs are not fully equipped to take up the responsibility of long term planning and execution especially for launching capital projects
- ❖ Lateral induction of talent from private sector & internships from management/educational institutions
- ❖ One of the biggest concerns for investors in ULBs arise from political risks
- ❖ Necessary to put in place all possible measures to insulate project financing structures from political interference or decisions based on political and other external considerations – ring-fencing of tariff & other revenue streams

# *CONCLUDING THOUGHTS*



- ❖ In the coming years, Indian cities are going to be central to its economic future
- ❖ India has a young and rapidly growing population and presents the country with a great opportunity to enhance its growth and seek convergence of per capita incomes with that in the developed world
- ❖ Need to create adequate jobs, particularly in the relatively more productive Indian urban sector and this requires investment in the cities



- ❖ From the perspective of globalization, cities not nations fight for investments
  - ❑ with India globalizing in a big way, there is a lot of focus on attracting FDI
  - ❑ our cities will host foreign companies including global banks, R&D centres as well as foreign nationals and non-resident Indians
  - ❑ there is an urgent need for improvement in city infrastructure, provision of quality services in cities and providing a decent quality of life to all its inhabitants
- ❖ Raising funds requires a multi pronged approach – generating adequate own resources, taking innovative measures to attract private capital, both internal and external, sector and taking the desirable reform measures
- ❖ Financing strategies should not be perceived as only a financial sector initiative
  - ❑ Efforts for creating a success story would largely depend on the competence of ULBs and improvement in the fiscal and regulatory environment of the ULBs
- ❖ Conference like this can provide a lot in terms of innovative ideas & practical strategies

*Thank you*

